THE DEVELOPMENT OF INTERBANK BORROWING IN THE NATIONAL SYSTEM 1869–1914

I. INTRODUCTORY

In the literature of banking and currency reform in the United States, comparatively little attention was until recently given to the interrelations of the thousands of banks in the national banking system, except in the matter of redeposited reserves. It is true that in the discussions which followed the breakdown of the banking system in 1893, banking interrelations were emphasized by the advocates of branch banking; but for the most part this school of reformers looked rather to future relationships than to those already existing. It was little appreciated that the system of interbank borrowing, which had already developed to such an extent that even in 1893 more than sixty millions of dollars were so borrowed, contained within itself a principle which might conceivably be extended to secure the very ends which the proponents of branch banking contemplated, namely, such mobility of loanable funds as would approximately equalize rates of interest throughout the country. This possibility was obscured by the trend of thought and of legislation toward greater freedom of note issue. It did not, indeed, escape attention that the variations in the volume of interbank borrowing formed a very satisfactory index of the needed elasticity;[1] but it was not until the need of credit elasticity as well as of currency elasticity[2] began to be perceived that any considerable importance was attached to the existing relations of banks with one another.

[1] See *Report of the* (Indianapolis) *Monetary Commission* (Indianapolis, 1900), pp. 321–22; also *Report of the Comptroller of the Currency*, 1899, p. xvi, in which Mr. Dawes deduces an argument in favor of his plan for an emergency currency from a comparison of the amount of borrowings with the increase in bank-note issues which his plan would permit.

[2] One of the first writers to draw this distinction was F. A. Cleveland, in *The Bank and the Treasury* (New York, 1905), chaps. v, vi, especially pp. 66, 67.

The rediscounting of commercial paper has been commonly supposed to have been introduced into this country in 1914. In point of fact, it was a recognized practice at least as early as the establishment of the national banking system. This article will trace the development of this practice and of the related practice of direct borrowing within the national system, and will show how the restrictions of law hampered the usefulness of interbank borrowing in this country until the Gordian knot was cut by the passage of the Federal Reserve Act.

The present study is limited, in the main, to the borrowing operations of the national banks, principally because of the paucity of material relating to the borrowings of state institutions. Detailed information concerning all the state banks goes back but a few years and relates to but one date in each year.[1] On the other hand, the statistical data relative to borrowings in the national system go back almost to the beginning of the system. The study is therefore limited in time to the period extending from April 17, 1869, to October 31, 1914.[2] The primary interest of the paper is, furthermore, to examine the use of the various forms of commercial paper as a liquid resource and the facilities afforded for such use by the national banking system. The conversion or hypothecation of other securities as a means of obtaining ready funds accordingly receives little attention.

Aside from the statistical data published in the reports of the Comptroller of the Currency, there is little printed material to be had on the subject of borrowing among national banks. In the text of the Comptroller's reports there is seldom more than perfunctory statement of the amount of borrowings. The textbooks on banking give at most a brief reference to the practice, although the trend of recent movements for banking reform has made for

[1] There was no very satisfactory compilation of this information prior to 1909. On April 28 of that year, the amount of money borrowed by state banking institutions was approximately $65,000,000; while on June 30, 1914, it aggregated $141,000,000. Borrowing by state institutions is larger than that by national banks, both absolutely and relatively to capital liabilities.

[2] The sixth call of 1914 is omitted because the Federal Reserve banks were then in operation, and the amount of notes and bills rediscounted was possibly affected by that fact.

fuller discussion of the subject in the books. Some material is to be found in the technical banking journals and in the financial press, and also in the report of the hearings before the Senate Committee on Banking and Currency. This material has been supplemented by a considerable number of interviews with bankers, without whose courteous co-operation many points must have remained unclear.[1]

II. THE GENERAL CHARACTER OF INTERBANK BORROWING

The immediate motive for borrowing by banks is the need—actual or anticipated—of increasing the bank's supply of ready funds, whether it be reserve money, till cash, or balances maintained in other banks for exchange or reserve purposes. In most cases this shortage of funds is the result of those seasonal or cyclical variations in the demand for money or loans which gave rise to the agitation for greater flexibility and centralization in our banking and currency system, culminating in the establishment of the Federal Reserve banks. The causes and characteristics of these variations in demand have been made clear in the abundant literature on banking and currency reform in this country, and require no extensive discussion here. For the most part, the seasonal variations are the outgrowth of the dominance of agriculture in our national industry;[2] but there are other and less generally recognized causes of variations which not infrequently lead banks to borrow. Among these may be mentioned the requirements of the holiday trade and of end-of-the-year settlements, and the provision of pay-roll cash in manufacturing communities.[3] Other variations

[1] In many cases, statements in the text rest solely on the authority of these interviews; but printed authorities have been cited wherever it has been possible to do so. I am also under obligations to the librarian of the Library of the American Bankers' Association for extending to me the privileges of that notable collection of literature on practical banking.

[2] A. Piatt Andrew, "The Influence of the Crops upon Business in America," *Quarterly Journal of Economics*, XX (May, 1906), 323–53.

[3] As to the situation in the New England mill towns, see the testimony of Mr. J. E. Varney, *Banking and Currency Hearings*, II, 1249 (63d Cong., 1st Sess., *Sen. Doc.*, Vols. XV, XVI, XVII).

are still more local in character or are confined to particular banks, and do not, therefore, lend themselves to general treatment.[1]

Lying back of the shortage of ready funds which is the immediate cause of bank borrowing is in many cases the more fundamental need of providing for a more or less temporary expansion of loans, or, it may be, of supplementing a chronic insufficiency of capital resources or loanable funds.[2] Under any banking law which requires a fixed and relatively high reserve, such as that required by the National Bank Act prior to 1914, no considerable loan expansion is ordinarily possible unless the reserve can be augmented, for the banks naturally avoid carrying any large surplus reserve. If the loan demand happens to coincide with a drain of cash, the limit of lending power is more quickly reached. The only immediate remedy for this situation lies in borrowing[3] or in the conversion of securities or other assets; but since the sale of securities is likely to involve loss, borrowing seems to be more generally resorted to among national banks.[4]

It may perhaps be doubted whether interbank borrowing may fairly be said to be due to chronic insufficiency of banking resources. It would be more accurate to say that where there are extreme seasonal variations in the demand for money and loans, these resources are likely to be insufficient at the height of the demand;

[1] Out of such variations as these arose the practice of lending and borrowing credit balances at the Boston Clearing-House. See J. G. Cannon, *Clearing Houses* (Washington, 1910), pp. 242–58; C. B. Patten, *Practical Banking* (New York, 1902), pp. 355–57. Mr. C. A. Ruggles, manager of the Boston Clearing-House, informs me that this practice is now a thing of the past. When used, the banks reported these borrowings to the Comptroller as bills payable. The lending and borrowing of balances is to be distinguished from the Chicago plan of trading balances, which has the same effect, so far as it goes, as the settlement of balances by means of the manager's check on debtor banks. Cf. Cannon, *op. cit.*, pp. 284–88.

[2] Cf. O. M. W. Sprague, *Banking Reform in the United States* (Cambridge, 1911), p. 169, note.

[3] See the statement of Sir Edm. Walker that without legal reserves we might not require provision for rediscounting. *Hearings before the Subcommittee of the* (House) *Committee on Banking and Currency*, Part 11, February 5, 1913, p. 643.

[4] Professor Hollander finds little evidence of the liquidation of security holdings during the normal autumnal stringency. "The Security Holdings of National Banks," *American Economic Review*, III (December, 1913), 783–814, especially p. 808.

for it may be impractical to provide banking facilities adequate to the largest demand without loss during the periods of inactive demand. This situation is most marked in the southern states, where the virtual one-crop system tends to concentrate the demand within a comparatively short period.

Interbank borrowing takes place in this country under a variety of forms,[1] of which only two may be definitely identified in the reports of the Comptroller of the Currency. These are "notes and bills rediscounted" and "bills payable." These two forms doubtless comprise the great bulk of borrowings, although banks not infrequently borrow by overdraft on balances with correspondents or by the issue of certificates of deposit in favor of the lending bank.[2] The reluctance of lending banks to accept such unsecured claims as overdrafts[3] or certificates accounts for their comparatively slight use; for borrowing banks would in many cases be more than willing to conceal their borrowings by reporting them in the noncommittal items of "certificates of deposit" and "due to banks and bankers." Moreover, the Comptroller has long required that certificates of deposit representing money borrowed be reported as bills payable. For these reasons there is probably little error involved in the enforced omission of borrowings included in overdrafts and certificates of deposit from statements of the amount of money borrowed.

Borrowings may also be concealed in the item "other liabilities," although careful administration of the national bank act may prevent this abuse. For a time, the Comptroller's Office impliedly sanctioned this practice by including other liabilities in its statement of the amount of "money borrowed in different forms." Certainly no considerable amount of borrowings is now reported

[1] Cf. H. G. Moulton, *Principles of Money and Banking* (Chicago, 1916), Part II, pp. 123, 124.

[2] These four forms are those mentioned by Montgomery Rollins, *Money and Investments* (Boston, 1907), p. 332. See also George M. Coffin, *The ABC of Banks and Banking* (New York, 1903), pp. 67–68.

[3] The correspondent bank is sometimes protected against a possible overdraft by a deposit of securities. See *Hearings*, III, 2353. But if these secured overdrafts are not so published, the holder may, in case of bankruptcy, be held to have been unduly privileged.

under the head of other liabilities, for this item has not been large for some years.

Interbank borrowing may, however, occur under forms which do not appear at all in the published statements of the bank's condition. The forms under which the Comptroller of the Currency suspected the concealment of borrowings may be inferred from changes made in the schedule of bills payable in the blank forms for periodical reports of condition. In 1913, notes or securities sold with agreement to repurchase were required to be reported with bills payable, and in 1914 "bills receivable rediscounted for bank's benefit without recourse on bank but with indorsement or other guaranty of officer or director of bank" were required to be so included. It may fairly be assumed that obligations coming strictly within these descriptions have been reported since these changes were made; and it is not probable that there is still any very large amount of such concealment. Aside from the vigilance of the Comptroller's Office, the chief influence making for their reduction is the growing reluctance of lending banks to be a party to such arrangements.[1] As one banker put it: "We object to indirect loans as reflecting on both borrower and lender."

Perhaps the most common method of concealment has been by the use of the personal credit of some of the officers or directors of the borrowing bank.[2] This method is most likely to be used when the bank is practically owned by the borrowing officers, who might otherwise hesitate to bind themselves for the benefit of the bank, even though the bank could not escape its liability for "money had and received."[3] Sometimes the note of the directors or officers serves merely as collateral security for a virtual overdraft; the borrowing bank is charged by the lender in a special account and credited in the general account, so that the borrowing

[1] *New York Times*, August 14, 1913. It was then stated that the practice continued to be general in Chicago and St. Louis.

[2] See the testimony of Mr. F. S. Larrabee, *Hearings*, III, 2357.

[3] J. T. Morse, Jr., *The Law of Banks and Banking*, sec. 149 (3d ed., Boston, 1888). See also *Chemical National Bank of Chicago* vs. *City Bank of Portage*, 156 Illinois Reports, 149 (1895), where the plaintiff was held for money received from the sale of the cashier's note through a broker; and compare *Aldrich* vs. *Chemical National Bank*, 176 United States Reports, 618 (1900).

bank reports the loan as "due to banks." Again, officers occasionally procure a loan for their bank on their own notes with the bank's indorsement or guaranty;[1] but this is in reality nothing more than the rediscount of accommodation paper, which the bank has long been required to report.[2]

Another method for the concealment of borrowings, slightly different in form and in the security of the lending bank, is the nominal sale to the directors or officers of some of the bank's bills receivable, indorsed without recourse; the paper so purchased is then indorsed, and rediscounted or pledged as collateral for a loan with another bank.[3] Inasmuch as the sale of large amounts of paper to the bank's officers or directors is a circumstance which should arouse the suspicions of an alert bank examiner, directors in many cases formed corporations for the sole purpose of handling such transactions in order to throw the examiner off the scent. In these cases the bank's concealed borrowings are unlikely to be detected.[4]

Banks also frequently dispose of some of their assets to city banks under conditions which are practically equivalent to the negotiation of a loan, but which have been thought to obviate the necessity of reporting any liability for money borrowed. Notes may be sold by the bank with guaranty of payment, and although the contingent liability thus incurred is the same as in the case of rediscount, it is said that it has not commonly been reported in the bank's statements.[5] Banks were not until recently required to make any report of a very similar transaction, in which the bank sells securities or bills receivable accompanied by an agreement to repurchase them on demand or at a specified date at a price enough higher to yield interest to the purchasing bank on the quasi-loan. Besides its covert character, this method has the advantage of enabling the selling bank to secure an advance equal to the full

[1] *Cochran* vs. *Sayre*, 157 United States Reports, 286 (1895); *New York Times*, August 14, 1913.

[2] *Ibid.*

[3] *Gulf State Banker*, September, 1910; *New York Times*, August 14, 1913.

[4] *New York Times*, August 14, 1913.

[5] *Ibid.*

market value of its securities, while upon a direct loan the collateral deposited would ordinarily be expected to provide a margin.[1] These conditional sales of securities seem to be much more common among city banks than among country banks.

As to the amount of these concealed borrowings it is scarcely possible to do more than guess. Beginning with the fourth call for a report of condition in 1913 (August 9), there has been a consistent effort to secure a full statement of all obligations for money borrowed, whether openly or covertly. It was then estimated that the secret borrowings of the national banks aggregated from fifty to one hundred millions of dollars.[2]

It is now pertinent to inquire why borrowings were concealed. The principal reason is the general prejudice against bank borrowing which existed in this country until largely destroyed by familiarity with the operations of the Federal Reserve banks.[3] This prejudice was to some extent due to the dislike of customers to have their notes sent out of the bank in which they were originally negotiated,[4] although this feeling may have resulted merely from unfamiliarity with the practice. There also have been occasionally a tendency on the part of business men to avoid a borrowing bank through fear of the bank's inability to accommodate them at all

[1] *Wisconsin Banker*, November, 1910; *Banking Reform*, September 2, 1912, quoting the *Journal of Commerce; New York Times*, August 9, 14, and 16, 1913; Wm. G. Bliss, "The Need of Revised Bank Reports," *Annalist*, IV (November 9, 1914), 376. The conditional sale of securities may, however, be due to the desire of the purchasing bank to secure bonds for deposit with the treasury, and is then equivalent to the borrowing of bonds. When bills receivable are so sold, the transaction is indistinguishable from the repurchase of "commercial paper" by a note broker, except in the character of the parties and, perhaps, in the purchase price. See Babson and May, *Commercial Paper*, p. 208.

[2] *New York Times*, August 14, 1913, on the authority of a "former government official."

[3] Cf. Laughlin (Ed.), *Banking Reform*, p. 93. Partly, it would seem, as a result of the agitation for banking reform and partly through sheer force of the necessity imposed upon them in the crisis of 1907, the prejudice of the banks themselves against borrowing had for some time been declining. Evidence of this may be seen in the increased scale of borrowings since 1907 as well as in the expressions of bankers.

[4] *Bankers' Magazine*, LXXVIII (January, 1909), 13; *Hearings*, I, 702; II, 1261; III, 2114; Conway and Patterson, *The Operation of the New Bank Act* (Philadelphia, 1914), p. 109; *New York Times*, August 14, 1914.

times,[1] and there was a rather general belief that a borrowing bank is on the verge of insolvency.[2] Under such circumstances, a report which discloses borrowing is certain to be used by competitors to the disadvantage of the borrowing bank; and hence a deep prejudice against all forms of borrowing developed among bankers in most sections of the country.[3] This prejudice was particularly marked among bankers in the eastern states and in manufacturing districts; in the West it was somewhat less general, and in the South it scarcely existed.[4]

The prejudice against borrowing was not, however, shared to any considerable extent by the lending banks, for it is their experience that loans to correspondents are among the safest of their investments.[5] On the contrary, many bank officers thought that banks should be encouraged to borrow, since it is only through their frequent borrowing that the city bank can gain that degree of credit information which will lead it to support its country correspondent in emergencies; and borrowing, especially in emergencies, is commended in many quarters.[6]

[1] E. H. Sensenich before the Oregon State Bankers' Association, 1913 (excerpts in *Chronicle*, XCVII [July 5, 1913], 20); E. P. Wells, *Hearings*, I, 948.

[2] "Banks' Concealment of Loans by Rediscount," *Gulf State Banker*, September, 1910; Laughlin (Ed.), *Banking Reform*, p. 93; Sensenich, *loc. cit.; Hearings*, I, 702; C. S. Hamlin, *The Federal Reserve System as Established and in Operation* (Address before the New York Chamber of Commerce, December 3, 1914; pamphlet). Doubtless failing banks are generally borrowers, but this constitutes no valid ground for prejudice against borrowing.

[3] *Hearings*, I, 947–48; II, 1663, 1887; III, 2330, 2353, 2452; and references previously given under this paragraph. Occasionally the bankers naïvely imply that their chief objection is to the publicity given their borrowings. *Hearings*, II, 1553, 1663.

[4] Conway and Patterson, *op. cit.*, p. 94; *Bankers' Magazine*, LXXXVI (January, 1913), 4; *Hearings*, I, 106. Most of the southern bankers who appeared before the Senate Committee seemed to regard borrowing as a matter of course; but see the testimony of F. W. Foote, *loc. cit.*, II, 1531.

[5] The officers of some of the large lending banks in New York state that in years their banks have not lost a penny in such loans. See also T. Gilman, *A Graded Banking System* (Boston, 1898), p. 97; and *New York Evening Post*, August 9, 1913.

[6] Russel Lowry, before the Washington Bankers' Convention (Walla Walla), 1914 (excerpts in news clippings of June 9, 1914); *New York Times*, August 14, 1913; Sprague, *Banking Reform in the United States*, p. 169, note. Many bankers, even while averse to borrowing, expressed a desire for the establishment of an institution which could with certainty lend them assistance in periods of stress. *Hearings*, *passim.*

Aside from the prejudice against borrowing, the most potent reason for its concealment was the limitation upon liabilities imposed by the National Bank Act, which provides that except for circulating notes, deposits, drafts upon deposits with correspondents, and liabilities to stockholders for dividends and reserve profits, "no association shall at any time be indebted, or in any way liable, to an amount exceeding its capital stock. . . . ."[1] This limitation does not operate to cut off loans to the needy bank, for the violation of the statute does not void the debt.[2] Especially in agricultural districts, banks not infrequently require to borrow to a greater amount than their capital,[3] and in such contingencies make use of some of the devices which have been mentioned for avoiding statement of the bank's liability. The Comptroller's Office has not found it practicable to prevent violations of the statute; and that they were not more frequent is apparently due less to the law than to prejudice against borrowing and to the restricted scope of the discount market.[4]

From the point of view of banking reform, the rediscounting of notes and bills held by the bank is the most interesting and significant form of borrowing among banks. It ought not in strictness to be

[1] *Revised Statutes*, sec. 5202. To the above-mentioned exceptions have been added liabilities incurred under the provisions of the Federal Reserve and War Finance Corporation Acts. See sec. 20, Act of April 5, 1918. For present purposes, the significant change is the removal of the limitation upon the rediscount of paper, provided it is sold to the Federal Reserve bank; but the Federal Reserve Board may impose restrictions and limitations upon rediscount. Act of December 23, 1913, sec. 13.

[2] *Weber* vs. *Spokane National Bank*, 64 Federal Reporter, 208 (1894); *Chemical National Bank* vs. *City Bank of Portage*, 156 Illinois Reports, 149 (1895).

[3] Several bankers testified that they had borrowed from two to five and a half times their capital. *Hearings*, I, 106; II, 1570; III, 2356, 2357. Still others objected to the proposed limitation of rediscounts to the amount of the capital stock. Other statements as to the amount needed are in *Hearings*, II, 1520, 1547, 1626, 1643; and see also *Hearings before the Subcommittee of the* (House) *Committee on Banking and Currency*, Part 11, February 5, 1913, p. 632, and *New York Times*, August 14, 1913.

[4] The percentage of banks violating the statute in the years 1909–11 is given in the *Reports of the Comptroller*, 1910, p. 11; 1911, p. 18. Again in 1914 the Comptroller complains of violations and discusses the practical difficulty of enforcing this and other prohibitions of the Banking Act for want of appropriate penalties. *Report*, 1914, pp. 16–17.

regarded as a form of borrowing, but rather as a sale of assets,[1] just as a merchant or manufacturer who offers for discount the promissory notes received from his customers is considered merely to be converting some of his assets into ready funds. In the eyes of the law, however, a contingent liability attaches to the one who indorses the note for discount, whether banker or merchant. This liability is recognized in the bookkeeping entries by which rediscounts are recorded. Prior to 1916, the item "loans and discounts" was not reduced by the amount of the rediscounted note,[2] as might have been expected, but among the liabilities a new item of "notes and bills rediscounted" was set up, balanced among the resources by an increase in the amount of cash or in the amount due from banks.[3] Since September, 1916, liabilities for rediscounts have been appended to the statement of condition rather than incorporated in it.

While both law and banking practice warrant the inclusion of rediscounting among the forms of borrowing, there is a more important reason for the classification. Perhaps in part because of the contingent liability which rediscounting involves, but in much larger part, it is believed, because of the great number of small banks and the lack of a recognized discount market where one might be as sure of selling good commercial paper as of selling standard stocks and bonds, the purchase of paper was not based primarily on the credit of its maker and was even regarded as a

[1] Cf. *United States National Bank* vs. *First National Bank*, 79 Federal Reporter, 296 (1897).

[2] Whence it follows that the aggregate of loans and discounts given in the reports of the Comptroller somewhat overstated the amount of borrowing by the public.

[3] Accounting authorities are not agreed as to the correctness of this practice. Professor Hatfield approves it on the ground of the essential similarity of rediscount and direct borrowing with bills receivable as collateral; see *Modern Accounting*, pp. 32, 192–93. On the other hand, Professor W. M. Cole says: "This contingent liability for endorsed notes obviously cannot appear on the balance sheet, for it does not appear as a liability on the books. It can appear only in a supplementary statement or appended note." *Accounts* (Boston, n.d.), p. 95. Mr. Wm. G. Bliss would treat the liability similarly, on the ground—in marked contrast with Professor Hatfield's argument—that bank statements should recognize the vital difference between borrowing and rediscounting, the neglect of which has led to the prejudice against rediscount. "The Need of Revised Bank Reports," *Annalist*, IV (November 9, 1914), 376.

privilege or favor granted by the buyer to the seller of the paper.[1] Rediscounting thus became in fact a borrowing operation, involving the credit of the selling bank.[2]

The analogy between promissory notes and stocks or bonds as marketable securities is of course far from perfect, since the notes do not so readily lend themselves to standardization. The indorsement of the selling bank, however, approximates standardization. To be sure, the claim upon the bank is not direct and immediate, but the purchaser in fact looks primarily to the seller for the payment of maturing paper. From this point of view, the need for bank acceptances in remedying our credit system has been somewhat exaggerated. For the acceptance has intrinsically no greater claim to standard and uniform quality than has the rediscounted paper. In Europe, accepting houses are fewer in number and stronger in resources and credit than the banks which commonly indorse their paper for rediscount in this country; it does not appear, however, that our rediscounted paper is less safe than the European acceptance.[3] Nor does the fact that the acceptance usually indicates its commercial origin necessarily give it greater strength than the promissory note.[4] The strength of any paper is a question merely of the strength of the names it bears, and uniformity of quality implies approximate uniformity of strength.

The real advantage of the bank acceptance over the rediscounted promissory note lies in the fact that it is undeniably a more liquid form of paper. This is because the acceptor's credit

[1] Laughlin (Ed.), *Banking Reform*, pp. 21, 258, 267.

[2] *Ibid.*, p. 93. There exists, however, a considerable amount of rediscounting which in no way involves the credit of the selling bank. City banks sometimes supply the investment needs of their interior correspondents by selling paper from their own portfolios with qualified indorsements. In this the city banks are little more than note brokers. See the report of the New York superintendent of banks, cited in *Bradstreet's*, XLI (December 20, 1913), 804.

[3] The usual criticisms of the quality of rediscounted local paper as compared with acceptances neglect the fact that under decentralized banking acceptances are neither uniform nor necessarily safe. See Laughlin, *op. cit.*, pp. 49–50.

[4] Sprague, "Commercial Paper and the Federal Reserve Banks," *Journal of Political Economy*, XXII (May, 1914), 436–43. See also Sprague, *Banking Reform in the United States*, pp. 168–70, and Beverly D. Harris, *Progress in the Development of Trade Acceptances* (New York), pp. 8–9.

standing is usually more widely known than that of the maker of the note. Conditions may be imagined under which rediscounted promissory notes would be as liquid and as uniform in quality as bank acceptances, but these conditions are not to be found where the banking system consists of a great number of independent banks of varying resources and character. In this country the smaller banks will no doubt continue to lend chiefly on promissory notes and to pledge their credit by rediscounting these as need arises with their correspondents or with the Federal Reserve banks. The credit standing of such rediscounted notes cannot be made equal to that of the acceptance of a large bank unless it is again indorsed by a large bank. It is therefore unlikely that notes of this description will be resold, while prime acceptances may be sold again and again without involving the credit of the seller to an appreciable extent, and may command an international as well as a national market.

But it must not be forgotten that no paper can be liquid if the market for it is likely to fail at the critical moment of need. The major reform effected in our banking system under the Federal Reserve Act was the establishment of the Federal Reserve banks—not the improvement in the forms of commercial paper which it encouraged.[1]

Generally speaking, the banker who applies for a rediscount will select what he regards as his best paper, although his judgment is naturally affected by what he conceives to be the standards of the lending banker. There seems to be a tendency to offer paper of the larger denominations. In the larger cities, the paper held in the banks' portfolios may easily meet the requirements of the lending bank, for it is often from the best-known firms. In the smaller cities

[1] Most discussions of the forms of commercial paper neglect the important fact that no paper can be liquid in the absence of a discount market. The general subject may be examined in the collected writings of P. M. Warburg, in the *Proceedings of the Academy of Political Science*, Vol. IV, No. 4, especially "The Discount System in Europe" (also published separately by the National Monetary Commission, Washington, 1910); L. M. Jacobs, *Bank Acceptances;* Sprague, *Banking Reform* and "Commercial Paper and the Federal Reserve Banks," *Journal of Political Economy*, XXII (May, 1914), 436–43; and E. E. Agger, "The Commercial Paper Debate," *Journal of Political Economy*, XXII (July, 1914), 661 ff. Babson and May, *Commercial Paper*, contains a less satisfactory discussion.

and country towns, however, the bulk of the paper coming into the banks is often not such as meets the ideas of the city banker as to what is first-class paper. Farmers' paper is particularly likely to fall under condemnation because of the notorious carelessness of farmers in taking care of their paper at maturity.[1] This carelessness renders the paper unsatisfactory to the borrowing bank as well, and probably helps to explain the preference for direct loans, or bills payable.

The negotiation of the bank's own paper, generally secured by collateral, has been much the more common form of borrowing. The form of collateral note given is substantially similar to that used for individual collateral loans, and carries a pledge of any property left with, or coming into the possession of, the lending bank, including any deposit balance. The collateral specially pledged for the loan sometimes consists of stocks and bonds, but it is usually some of the bank's bills receivable. In contrast with the denominations of paper rediscounted, the paper offered and accepted as collateral security is frequently very small, running as low as five dollars; so that the bundles of collateral forwarded with the application for a loan[2] are sometimes enormous. This small paper is often preferred by the lending banks because it represents the cream of the borrowing bank's paper, so far as certainty of payment at maturity goes. It may be added that the chances of serious defaults are smaller among a large number of small notes.

As a rule the collateral deposited provides a margin of 20 per cent above the amount of the loan; but the margin varies with the credit of the borrowing bank, often running up to 50, sometimes even to 100 per cent.[3] This margin of security afforded by the collateral is the principal reason why bankers ordinarily prefer to lend on the direct obligation of the borrowing bank, rather than to accept paper for rediscount.[4] On the other hand, in some cases no collateral at all is required, but this seems to be quite unusual.

[1] *New York Times*, September 25, 1914.

[2] Since the line of credit has previously been agreed upon, the borrowing bank commonly sends its note with the collateral and draws at once, if need be, upon the expected credit. *Hearings*, II, 1524, 1568.

[3] Mr. F. E. Marshall speaks of a margin of 35 or 40 per cent as if it were usual. *Hearings*, I, 472.

[4] *Ibid.*

It is frequently stated that borrowing banks fear the displeasure of those customers whose paper is rediscounted. In order to avoid disclosing the discount, the notes may be indorsed in pencil and the indorsement erased when the note is returned for presentment and payment. Another common method is to have notes made payable to the maker and indorsed by him; in this negotiable form they are ordinarily acceptable as collateral without the bank's indorsement, but not for rediscount.[1] In rare cases the lending bank may accept in lieu of indorsement a power of attorney authorizing it to indorse the paper in case of need. Again, the borrowing bank may conceal its use of the customer's paper by giving a separate contract of guaranty,[2] but this method appears to be unusual.

In any of these cases except the loan without collateral, the concealment of the use of customers' paper may occasionally be defeated by prepayment of the notes. In order to obviate this possibility, exceptionally cautious banks sometimes request that their receivables be immediately returned to their custody under a trust receipt.[3]

The principal explanation of the relatively slight use of rediscounting is to be found in the preference of the lending banks for the borrower's own note secured by collateral. The chief reason for this preference is the margin of security afforded; where the loan is unsecured there is little choice between the bill payable and the rediscounted bill receivable. There is somewhat greater control of maturities in the case of bills payable, but in any case the maturities must ordinarily be adjusted to the time when the borrowing

[1] The indorsement may, however, be made either by pencil or by rubber stamp accompanied by a letter showing authority to use the stamp; and in such cases the use of the paper in borrowing may be concealed from the customer.

[2] An indorsement may be on an *allonge* "whenever the necessity or convenience of the parties may require it." E. W. Huffcutt, *Negotiable Instruments* (New York, 1898), p. 21. It would therefore seem that the indorsement might be concealed from customers by the device of removing the *allonge;* and that this practice is sometimes followed is suggested by an opinion of counsel in *Federal Reserve Bulletin,* II (November, 1916), 610–11.

[3] *Hearings,* II, 1261; III, 2114. Cf. also III, 2357, for a somewhat similar method of borrowing on the bank's own note, to which is attached an account of its bills receivable.

bank's loans are falling in. The direct form of the obligation is of no particular advantage to the lender, for the borrowing bank must protect the lender against the default of the maker of rediscounted paper in order to maintain its credit standing, even if it were not contingently liable. If we had had a discount market, the direct loan would probably not have been preferred.

What, now, have been the variations in the relative use of rediscounts and bills payable as instruments of interbank borrowing? At the first four calls at which borrowings were reported, rediscounts exceeded bills payable in amount; but from March 24, 1870, until October 3, 1882, the greater part of borrowings was in the form of bills payable, except at five scattered calls. In the decade following, the amount of rediscounts exceeded that of direct loans. Beginning with 1893 there was a complete reversal in the relative use of the two methods of borrowing, and the proportion of rediscounts steadily fell to about one-sixth of total borrowings, as compared with an average of 44 per cent in 1869–82, and 72 per cent in 1882–92.

I know of no entirely adequate explanation of these variations in relative use. The problem is the more baffling because of the abruptness of the changes. There is no gradual increase in the relative use of rediscounts to be observed in the period 1870–82, nor diminution in the decade 1883–92. The impairment of security which immediately preceded and accompanied the crisis of 1893 is the most satisfactory explanation of the change in that year, for under such conditions lenders would desire the additional protection afforded by a margin of collateral. It would seem, however, that the imminence of business disaster was not sufficiently apparent, or at least not so generally recognized, as to lead to so sudden and marked a change in the methods of bank borrowing as that which occurred between December 9, 1892, and March 6, 1893.[1]

[1] This connection of the change with the crisis was suggested by a New York banker, who thought that country banks—the principal borrowers—had been unable to find acceptable paper for rediscount, while city bankers have paper of higher grade. But (at the fourth calls) borrowings of country banks on bills payable did not exceed their rediscounts until 1897, although there was a sharp decline in the proportion of rediscounts between 1892 and 1893. Of course, many reserve city banks would usually be regarded as country banks. Deputy Comptroller T. P. Kane, who has had

The shift from the predominant use of bills payable to rediscounts which occurred in 1882 is plausibly explained by the fact that eligible commercial paper seems to have become more plentiful about that time.[1]

As compared with direct borrowing, rediscounting is more common in the southern states than in other sections. At eighty-eight out of ninety calls between 1897 and 1914, the percentage ratio of rediscounts to total borrowings in the south exceeded the ratio for the country as a whole. But at only eight calls, all of which were earlier than 1905, has the amount of rediscounts exceeded the amount of direct loans; and the ratio has been declining until in recent years it is not greatly in excess of the ratio for the country as a whole.

Borrowing in the strict sense, as distinguished from the acceptance of deposits, is not in law regarded as part of the business of banking; yet a bank has an inherent right to borrow whenever it is reasonably necessary in the proper conduct of its business. Aside from the theory of the law, since no one but the bank can well judge of the necessity, "the practical fact is that a bank can borrow whenever it wishes to, and if the money is used in its proper business, no fault will be found. . . . ."[2] While the National Bank Act does not specifically authorize borrowing, it does

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long experience in the Bureau of the Currency, does not distinguish between country and city paper, but writes me as follows:

"During the few months preceding the panics of 1893 and 1899 the lending banks were unwilling to accept commercial paper on account of the uncertainty of the security, and the borrowing banks were compelled to put up their bills receivable as security. This practice on the part of the large banks has prevailed from that time to the present, which has resulted in the predominance of bills payable over rediscounts as a form of borrowing. This condition is also due, no doubt, to the fact that the borrowing banks have been able to sell commercial paper without recourse to a large extent."

[1] Quoting again from Deputy Comptroller Kane:

"During the decade between 1882 and 1892 the banks rediscounted as a means of borrowing presumably for the reason that eligible commercial paper was plentiful and the large banks were willing to discount good paper for the country banks."

[2] Morse, *The Law of Banks and Banking*, sec. 63. I find no authority in support of Mr. Coffin's statement that the theory of the law is based on the seasonal demand for crop-moving; see *The ABC of Banks and Banking*, p. 67.

not prohibit it;[1] and the restriction placed in the Act upon indebtedness may even be held impliedly to authorize borrowing by recognizing its existence.[2] It has accordingly been held in a series of decisions that a national bank may guarantee notes the proceeds of which it enjoyed; may borrow money temporarily, or on call, or may give its time obligations or a mere oral contract; and may rediscount its bills receivable.[3]

The authority to borrow, of course, rests primarily in the board of directors, but they may authorize the president or cashier or both of them jointly to borrow money and to indorse the bank's notes. It was formerly held that the delegation of authority must be specific and that the power to borrow could not be regarded as inherent in the officers; although authority might be assumed if the directors, having official knowledge of an officer's borrowing, failed to repudiate it.[4] More recently, banking usage has been accepted as sufficient warrant for borrowing by the executive officers of a bank, and the officers of lending banks may rely on this customary authority in the absence of notice to the contrary.[5]

[1] *Wyman* vs. *Wallace*, 201 United States Reports, 230 (1906).

[2] Sec. 5202, *Revised Statutes*. *Eastern Townships Bank* vs. *Vermont National Bank*, 22 Federal Reporter, 186 (1884); *Report of the Comptroller*, 1890, pp. 12–13.

[3] *People's Bank* vs. *Manufacturers' National Bank*, 101 United States Reports, 181 (1879), where the power to transfer with indorsement or guaranty is deduced from the power of "discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt," and see Morse, *op. cit.*, sec. 65; *Western National Bank* vs. *Armstrong*, 152 United States Reports, 346 (1893); *Chemical National Bank* vs. *Armstrong*, 76 Federal Reporter, 339 (1896); *Wyman* vs. *Wallace*, 201 United States Reports, 230 (1906); *Hanover National Bank* vs. *First National Bank*, 109 Federal Reporter, 421 (1901); *United States National Bank* vs. *First National Bank*, 79 Federal Reporter, 296 (1897).

[4] "Such transactions would be so much out of the course of ordinary and legitimate banking as to require those making the loan to see to it that the officer or agent acting for the bank had special authority to borrow money." *Western National Bank* vs. *Armstrong*, 152 United States Reports, 346; see also *National Bank of Commerce* vs. *Atkinson*, 55 Federal Reporter, 465 (1893), and Morse, *op. cit.*, sec. 63, note (1), and 171. As to the cashier's inherent power, Morse is self-contradictory. Cf. secs. 160 and 165 (*d*). But the contradiction turns on a nice distinction between "inherent power" and the right of the prospective creditor to assume express or implied authority on the ground of banking usage.

[5] *Armstrong* vs. *Chemical National Bank*, 83 Federal Reporter, 556 (1897); *First National Bank* vs. *Arnold*, 156 Indiana Reports, 487; *City National Bank* vs. *Chemical National Bank*, 80 Federal Reporter, 859 (1897). In all these cases, the funds received

And even if authority is lacking, the retention and enjoyment of the fruits of the contract render the bank liable for money had and received.[1]

General arrangements for borrowing are usually made at the time of opening correspondent relations.[2] In recent years an investigation of the credit standing of the depositing bank is regularly made before the acceptance of the account; but before the credit department of banks had reached a high state of development the inquiry, if any, was comparatively superficial.[3] While it is probable, that investigations are still inadequate in many cases, statements of the bank's condition are regularly supplemented by such further inquiries as the resourcefulness of the credit man may suggest. The investigation seems to be the more searching if it appears that the depositing bank is likely to ask for large accommodation, and in the case of active borrowers it is the general practice to renew the investigation annually.

The line of credit is adjusted to the average balance carried by the depositing bank, as is the practice in individual loans. In

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were misapplied by the officers. It appears that the president of a bank may not bind it by the execution of a note in its name, but may do so if he exercises the functions of a cashier or has the actual management of its operations. *National Bank of Commerce* vs. *Atkinson*, 55 Federal Reporter, 465; *Simons et al.* vs. *Fisher*, *ibid.*, p. 905; *Hanover National Bank* vs. *First National Bank*, 109 Federal Reporter, 421. The president's implied power to indorse bills receivable for rediscounting has, however, been upheld on the ground that this is not borrowing. *United States National Bank* vs. *First National Bank*, 79 Federal Reporter, 296.

[1] *Armstrong* vs. *Chemical National Bank*, 176 United States Reports, 618 (1900); *People's Bank* vs. *Manufacturers' National Bank*, 101 United States Reports, 181; *Chemical National Bank* vs. *City Bank*, 156 Illinois Reports, 149 (1895); *Blanchard* vs. *Commercial Bank*, 75 Federal Reporter, 249 (1896); *American Exchange National Bank* vs. *First National Bank*, 82 Federal Reporter, 961 (1897)

[2] In *Auten* vs. *United States National Bank*, 174 United States Reports, 125, it appears that in response to the solicitation of a New York bank, a bank in Little Rock "opened business by inclosing for discount notes to a large amount." See also *Hearings*, II, 1568.

[3] For example, in 1899 an important New York bank agreed to facilitate covert borrowing in consideration of the transfer of the interior bank's New York account to itself. See *Hanover National Bank* vs. *First National Bank*, 109 Federal Reporter, 421. This could scarcely happen today. Comptroller Lacey recommended semiannual publication of the reports of individual banks partly on the ground that lending banks should be able to ascertain the condition of their correspondents more frequently. *Report*, 1890, p. 57.

New York the balance was formerly expected to amount to one-fifth of the line of credit extended.[1] The general adoption of this rule did a great deal to standardize the competition for interior correspondents, and it appears, on the whole, to be a salutary arrangement.[2]

The term for which the loan is made depends in the first instance on its character—whether rediscounted bills receivable or the direct obligation of the borrowing bank or its officers. If a rediscount, the term is of course determined by the maturity of the paper offered, although preference is given to the shorter maturities, not over six months.[3] The borrowing bank may, however, require accommodation continuing beyond the life of the paper rediscounted; in which case other paper may from time to time be substituted for that about to mature, either in pursuance of arrangements made at the time of borrowing or as a result of subsequent negotiations. If bills payable are offered, the term is agreed upon at the time; it may be at demand or for any period of time, but it rarely exceeds six months, although renewals and extensions may be granted with some freedom. This was very generally done in 1914, for example, particularly in the southern states, where the failure of the cotton market cut off the collections of the bankers and necessitated the extension of their own obligations.[4]

The rates of interest or discount on interbank borrowings vary within rather wide limits, but 6 per cent seems to have been the most common rate down to the establishment of the Federal Reserve System. This is a high rate, but it should be remembered that most loans are negotiated in autumn, when rates are normally

[1] "The New York banks have an ironclad rule that rediscounts shall not exceed from four to five times the balance carried by the borrowing bank. Conway and Patterson, *The Operation of the New Bank Act*, p. 95. See also Laughlin (Ed.), *Banking Reform*, p. 337. Because of the reduction in reserve requirements under the Federal Reserve Act, the ratio of loans to balances now tends to be higher.

[2] It has been objected, however, that under the rule rediscounts bear no relation to the needs of the bank or of its community. Conway and Patterson, *loc. cit.*

[3] Most loans of country banks fall due in November and December and rediscounting is not large until July or August; so that the most usual term of rediscount is probably from two to four months.

[4] *Chronicle*, XCIX, 1172. It is said that many extensions were required in 1913 also. *New York Times*, January 10, 1914; *Hearings*, II, 1276.

high in the lending centers and still higher in the agricultural districts in which most of the interbank borrowing occurs. Although rates appear to accord in a general way with the prevailing rates on time loans, what the borrowing bank receives on its own loans has an influence on the rate charged on its borrowings, which is usually such as to allow it some profit or commission.[1] This situation permits the rate to vary considerably even on loans made in the same place and at substantially the same time. The term of the loan, whether demand or time, the size of the borrowing bank, its credit and the amount of its balance may all affect the rate charged.[2] Of late, rates have been influenced by the rates in effect at the Federal Reserve banks, but the situation as it was prior to 1914 is well summed up in the remarks of two bankers, one of whom said: "Many borrowers, and sound ones, scarcely consider rates, but look upon a loan as almost a one-sided accommodation."[3] Another frankly stated that rates were then "all you can get away with." This, however, does not necessarily mean that the rate was ever usurious, but rather that it was adjusted to the circumstances of the particular case—in other words, that there was no discount market.[4]

[1] See testimony of William Ingle, Baltimore, in *Hearings*, III, 2412: "We are quarreled with when in tight times we charge an interior bank six per cent—which permits it no material profit, only one or two per cent." See also II, 1548, and Coffin, *The ABC of Banks and Banking*, p. 68. In so far as the borrowing bank makes loans of deposit credit rather than of cash, the true rate of profit is of course somewhat higher.

[2] *Journal of Commerce*, July 23, 1913; *Hearings*, II, 1627, 1643. See also the results of Secretary McAdoo's inquiry into rates charged borrowing correspondents. *Chronicle*, XCIX (October 3 and 10, 1914), 937, 1020, 1021.

[3] For corroboration of this statement, see *Journal of Commerce*, July 23, 1913, as to conditions in Philadelphia in 1913.

[4] The Comptroller of the Currency has for many years required the banks to show on their periodical reports the highest rate of interest paid on rediscounts and also on bills payable, but no compilation of rates has been published. The only published information on this subject is found in fugitive sources and in the testimony before the Senate Committee at its hearings on the Federal Reserve Banking Bill. The lowest recorded rate seems to be $1\frac{1}{2}$ per cent on a demand loan, which was made on the understanding that the money was needed chiefly as a balance with the New York correspondent. *American Exchange National Bank* vs. *First National Bank of Spokane Falls*, 82 Federal Reporter, 961 (1897). At the other extreme is the rate of 12 per cent charged by New York banks on rediscounts in the panic of 1893. Other

So long as our banking law required a minimum cash reserve and made no special provision for its speedy restoration when depleted, another factor sometimes affected the rates on interbank loans, although it affected their amount even more vitally. This was the character of the funds in which the proceeds of the loan were required. When the borrowing bank merely desired to increase its deposited reserve, loans could be made more readily and the rate of interest might on this account be lower.[1] To a less degree this was true even where the proceeds of the loan were used for exchange purposes rather than for reserve, for the funds were not likely to be withdrawn at once. Where the motive of the loan was not merely to build up the deposited reserve or the exchange account, but was instead to replenish the cash in bank or the home reserve after depletion by a currency drain or relative impairment as a result of increased loans, the state of funds in the lending bank was much more important. If the demand were merely for currency, as was often the case when the loan was made in anticipation of needs,[2] the lending bank might provide its own notes or the notes of other national banks it had on hand, without impairing or endangering its own legal reserve. There would seldom have been serious difficulty in supplying mere currency if the banks of the central reserve cities could have issued notes freely.[3] But aside from the inelastic character of national bank currency, difficulty often arose from the fact that the interior demand for currency was for lawful reserve money,[4] which could

rates mentioned vary from 4 to 6 per cent, except a rate of 8 per cent in 1893 and of 6 to 8 per cent in 1914, when rates above 7 per cent were said to be exceptional and to apply in only a few cases. A. D. Noyes, "The Banks and the Panic of 1893," *Political Science Quarterly*, IX (March, 1894), 20, note 2, reprinted in Sprague, *History of Crises*, p. 419, note. *Chronicle*, XCIX (October 3 and 10, 1914), 937, 1020.

[1] A New York bank offered a credit to a correspondent in 1907, but could not give cash. *Hearings*, II, 1527. See also the statement of Mr. Marshall as to the borrowings of southern banks for the planting demand in April and May: "That brings no stringency, because it is bank credit." *Ibid.*, I, 469. For the influence on rates, see *American Exchange National Bank* vs. *First National Bank*, 82 Federal Reporter, 961.

[2] For a case of anticipatory borrowing, see *Journal of Commerce*, July 23, 1913.

[3] *Bankers' Magazine*, LXXX (January, 1910), 9.

[4] *New York Evening Post*, September 6, 1913.

be supplied only at the expense of the lending bank's reserve. For these reasons, and because the chief demand for interbank loans coincided with the seasonal drain of currency, the making of loans to interior banks was a costly business and was of necessity done only at rather high rates during the harvesting and crop-moving season.[1] The operations of the Federal Reserve banks tend to moderate these rates because both city and country member banks are now able to replenish their reserve by rediscount at the Federal Reserve banks.

Our rigid reserve system and our inelastic bank-note currency were therefore the principal reasons for the relatively slight development of interbank borrowing before 1914 and for the failure of the national banks to control the normal autumnal stringency in loans and discount rates. But for these conditions, the call-money market would not have assumed so important a rôle in the operations of the great New York banks, and a broader discount market might have been developed. Rates on both loans and discounts would therefore have fluctuated within narrower limits and would have varied less widely among different sections.

It now remains to speak of the arrangements for collecting interbank loans. Inasmuch as rediscounted paper is in most instances payable at the bank of original discount, it is regularly returned for collection and at maturity is charged to the account of the discounting bank, by which remittance is made in due course. In the case of brokers' paper or paper payable elsewhere than at the bank which indorsed it, the note is handled as other collections, being sent to the place at which payable. Direct obligations of the borrowing bank are charged to its deposit balance, if that is large enough; otherwise they are held for remittance, together with the collateral which secured them. Collateral maturing before the secured loan matures may be returned for collection and other notes substituted for it, or in some cases payment may be made directly to the lending bank.[2]

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[1] See Laughlin (Ed.), *Banking Reform*, p. 315.

[2] *Hearings*, II, 1276.

[*To be continued*]